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Geneva, 20 January 1997
Item 2 of the provisional agenda

# PROVISIONAL AGENDA AND ANNOTATIONS

## I. PROVISIONAL AGENDA

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2. Adoption of the agenda and organization of work
3. Enterprise: issues relating to an enterprise development strategy
4. Services infrastructure for development and trade efficiency assessment
5. Provisional agenda for the second session of the Commission and any necessary preparation through expert meetings
6. Other business
7. Adoption of the report of the Commission to the Trade and Development Board.

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## II. ANNOTATIONS TO THE PROVISIONAL AGENDA

### Item 1 - Election of officers

1. Rule 18 of the rules of procedure of the main Committee of the Trade and Development Board states that: "At the commencement of the first meeting of each regular session, the Committee shall elect a Chairman, five Vice-Chairmen and a Rapporteur from among the representatives of its members. These officers shall constitute the Bureau of the Committee. In electing the officers, due account shall be taken of the need to ensure an equitable geographical distribution". Moreover, rule 19 indicates that "the Bureau of the Committee shall consist of seven members, including four members from Groups A and C combined, two members from Group B and one member from Group D, referred to in the annex to General Assembly resolution 1995 (XIX) as amended" (the revised lists of States annexed to the General Assembly resolution is contained in the report of the forty-third session of the Board, TD/B/43/12 (Vol.I)). In line with those arrangements, the Commission is required to elect a Chairman, five Vice-Chairmen and a Rapporteur to constitute the Bureau of its first session.

### Item 2 - Adoption of the agenda and organization of work

2. The provisional agenda in section I above was approved by the Trade and Development Board at its thirteenth executive session (8, July 1996). [1] As provided for in the UNCTAD calendar of meetings, the Commission will have available five working days from 20 to 24 January 1997. At the first plenary meeting, on 20 January 1997, an opening statement will be made by the Secretary-General of UNCTAD or his representative, followed by the introduction of item 3 and the general debate on this item. It is suggested that the rest of Monday 20 January and the morning of Tuesday 21 January 1997 be devoted to formal and informal discussions on item 3. On the afternoon of Tuesday 21 January, while continuing consideration of item 3, the Commission will also start its consideration of item 5 as it relates to item 3. On the morning of Wednesday 22 January 1997 the Commission will conclude consideration of item 3. On the afternoon of Wednesday 22 January 1997, an introductory statement will be made on item 4 of the agenda. The consideration of this item, in both an informal and formal setting, will continue until the afternoon of Thursday 23 January 1997. On Thursday afternoon, 23 January, the Commission will start consideration of item 5 as it relates to item 4. The Commission will conclude consideration of items 4 and 5 on Friday morning 24 January 1997. The report of the Commission will be adopted on the afternoon of Friday 24 January 1997.

### Item 3 - Enterprise: issues relating to an enterprise development strategy

3. The annotations on this item agreed upon at the thirteenth executive session of the Trade and Development Board read as follows: "The new dynamics of production and of enterprise development engendered by globalization, liberalization and technological change have focused attention on the need for developing and other countries to adopt a comprehensive and coherent national strategy for enterprise development, with a particular focus on SMEs, that will enable them to build up their enterprises as an essential instrument of development and of their enhanced participation in the world economy. While such a strategy is important for countries at all levels of development, it is particularly important for least developed countries which lack a mature enterprise or SME sector and which need to build up such a sector. Attention will be given to the main elements of such a strategy, including the policy and institutional implications, with a view to contributing to the identification of policy options, at both national and

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1 Report of the Trade and development Board on its thirteenth executive session (TD/B/EX(13)/2), annex III. C.

international levels, to enhance the role of domestic enterprises in development and in the global economy. Discussion on this issue will be facilitated by exchange of relevant experience. Particular reference will be made to (i) the role of Government-private sector dialogue in promoting enterprise development; (ii) measures of support for fostering the creation, development, efficiency, competitiveness and internationalization of enterprises, particularly SMEs, including through the establishment of enterprise linkages, both domestic and international, and issues of interrelationship between enterprise development and technology; and (iii) measures to address the effects of structural adjustment policies on enterprise development." [2]

4. Accordingly, the report for this session of the Commission contained in TD/B/COM.3/2 discusses:

(i) major developments and related policy issues concerning the changing nature of enterprises and of international competition;

(ii) national determinants of enterprise development and competitiveness in developing countries, with particular reference to LDCs, as well as in economies in transition; and

(iii) key issues relating to an enterprise development strategy, including an identification of areas for further work in respect of each issue, as well as the policy implications.

The latter topic can provide subjects for cross-country exchanges of national experiences at the Commission, which can help to identify policy elements for the formulation of enterprise development strategies, as well as supportive international action. The Commission may also wish to decide on a future work programme, including the identification of particular topics for further detailed consideration by expert meetings.

Item 4 - Services infrastructure for development and trade efficiency assessment

5. Te annotations on this item agreed upon at the thirteenth executive session of the Trade and Development Board read as follows: "UNCTAD's primary role in this sector is to assist developing countries, particularly the least developed countries, and countries in transition, in generating trade-supporting services such as customs, transportation, banking and insurance, telecommunications or business information which are adapted to their particular requirements. Several of these areas were also identified by the United Nations International Symposium on Trade Efficiency held in Columbus in October 1994, as being able significantly to improve participation in international trade (especially of weaker and small players). Within each of these sectors, the Commission can contribute to identifying priorities among the relevant policy issues and practical measures for a rapid enhancement of the objectives of trade efficiency worldwide, with special attention to the least developed countries. In this context, the Commission will be in a position to examine the possibility to invite experts to meet and address sectoral and cross-sectoral issues relevant to the follow-up of UNISTE. Based on the outcome of this work and that of the Commission itself, it will then be the Commission's responsibility to identify and pursue the policy opportunities raised by the Trade Efficiency Assessment exercise called for by UNCTAD IX. The Commission will take into account the close cooperation between UNCTAD, ECE, ITC and other relevant international organizations on these issues. An area of particular and immediate importance to most developing countries and economies in transition is that of transit, in which the practical experience acquired by UNCTAD (through programmes like ACIS, ASYCUDA and its work on corridor agreements), as well as the availability

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2 Ibid., item 3.

of new technologies, represents a capital that could be brought to rapid fruition. It is proposed that the Commission convene a first expert meeting to define the avenues and tools required to simplify implementation of transit agreements." [3]

6. Accordingly, the report for this session of the Commission contained in TD/B/COM.3/3 includes three parts:

(i) It describes the overall rationale, philosophy and originality of UNCTAD's work in the area of sServices infrastructure for development and trade efficiency, and its relevance to the needs of smaller players in a globalizing world economy;

(ii) It describes UNCTAD's work in each of the six trade-supporting areas addressed by UNISTE (Customs, transport, banking and insurance, trade facilitation, business information, and telecommunications) as well as in three major cross-sectoral areas (transit, human resources development, and legal issues). For each of these areas, the report offers answers to the following three major questions: What are the issues addressed? What are the actions envisaged and their development impact? In the coming year, what would be UNCTAD's priorities and what the expected results?

(iii) Practical proposals are made regarding future work of the Commission and UNCTAD, with special attention to the Trade Efficiency Assessment called for by UNCTAD IX.

Item 5 - Provisional agenda for the second session of the Commission and any necessary preparation through expert meetings

7. Paragraphs 18 and 19 of the report of the thirteenth session of the Trade and Development Board indicate that the draft provisional agenda and annotations for the first session of the Commission on Enterprise, Business Facilitation and Development was approved on the understandings that, when items 3 and 4 are taken up by the Commission, a review should be undertaken of the work to be done in the future and that the documentation prepared for these two items should also include the proposed future work programme of the Commission. The Commission may wish to establish the provisional agenda for its second session on the basis of its deliberation during its first session. In the UNCTAD indicative calendar of meetings for 1997, the second session of the Commission on Enterprise, Business Facilitation and Development is tentatively scheduled to take place from 1 to 5 December 1997.

Item 6 - Other business

8. Under this item, delegations may wish to raise any matter not covered under the other agenda items.

Item 7 - Adoption of the report of the Commission to the Trade and Development Board

9. The report of the Commission on its first session will be considered by the Trade and Development Board at its pre-sessional executive session to the forty-fourth session.

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[3] Ibid., item 4.

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Commission on Enterprise, Business
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# ENTERPRISE: ISSUES RELATING TO AN ENTERPRISE DEVELOPMENT STRATEGY

## The changing nature of enterprises and competition and the implications for the formulation of an enterprise development strategy

Issues paper by the UNCTAD secretariat

GE.96-52076 (E)

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## INTRODUCTION

1. Following the establishment of the Commission on Enterprise, Business Facilitation and Development by UNCTAD at its ninth session, the Trade and Development Board, by a decision taken at its thirteenth executive session, adopted the provisional agenda of the first session of the Commission.

2. This report has been prepared by the UNCTAD secretariat in order to facilitate consideration of item 3 of the provisional agenda, entitled: "Enterprise: issues relating to an enterprise development strategy". The report discusses major developments and related policy issues concerning the changing nature of enterprises and of international competition (chapter I); national determinants of enterprise development and competitiveness in developing countries, with particular reference to LDCs, as well as in economies in transition (chapter II); and key issues relating to an enterprise development strategy, including an identification of areas for further work in respect of each issue, as well as the policy implications (chapter III). The report highlights subjects for further research and cross-country exchanges of lessons learned and insights gained from national experiences in the Commission which can help to identify policy elements for the formulation of enterprise development strategies, as well as supportive international action. Based on its deliberations, which may also benefit from the participation of private sector actors, the Commission may also wish to decide on a future work programme, including the identification of particular topics for further detailed consideration by expert meetings.

## I. GLOBALIZATION AND THE CHANGING NATURE OF ENTERPRISES AND COMPETITION

### A. The new dynamics of enterprise development and competition

3. Globalization and liberalization in the world economy, facilitated by rapid advances in information and communications technologies, are creating new dynamics of enterprise development and competition. These forces are radically altering the **organization of enterprises**, as well as the organization of production, marketing and distribution, both domestically and globally. They are reshaping the notion of size of an enterprise as a competitive unit, obliging firms to seek the most efficient manner of organization in their particular field in terms of a variety of organizational strategies, such as vertical integration, specialization, subcontracting and partnering. In so doing, they are also transforming the nature of competition, which is increasingly taking place across and within industries internationally.

4. The **changing nature of competition** places a premium not only on price/quality relationships but also on firm-level ability to innovate and to adapt to changing circumstances and demands. In this perspective, firm-level competitiveness refers to the ability to produce goods and services that can stand the test of international competition, while upgrading technological capabilities. Such ability is also influenced by the sector in which a firm operates; the more innovative and competitive the sector is, the easier it is for the firm to adapt and to remain competitive, for example by exploiting externalities or "knowledge spillovers" through inter-firm cooperation. The

importance of innovation, and its R & D cost, have given rise to the duality of cooperation and competition. For example, firms which cooperate in R & D leading to the development of a common product and common standards may later, together with others, become competitors in making and marketing the final product. 1/

## B. Competitiveness and the role of innovation

5. Enterprises from developing countries and economies in transition, as well as those from developed countries, including those that have already established their presence in international markets, are thus being subjected to a new form of competition. Where such enterprises had previously enjoyed protection in local markets, liberalization is altering the rules of the game, subjecting domestic markets to international competition. Moreover, within the new global environment, consumer choices have widened and consumer preferences have become more diverse and volatile, adding to the intensity of competition facing enterprises. In this regard, achieving competitiveness requires the establishment of efficient distribution networks, speedy delivery systems, and a deeper knowledge of technology suppliers, competitors and customers' needs. Responsiveness to such needs through successful adjustment to the changing requirements of markets has become a critical dimension of competitiveness and requires innovative capabilities. 2/

6. The term **innovation**, in the context of the present discussion, refers not only to radical technological innovations which take place at the "frontiers of technology", but also to the continuous and incremental changes that are carried out by enterprises themselves in the course of organizing investment, creating production capacity, building and upgrading technological capabilities and generally learning to cope with changes. In this sense, innovation is defined as "the processes by which firms master and implement the design and production of goods and services that are new to them, irrespective of whether or not they are new to their competitors - domestic or foreign" (Ernst, Mytelka and Ganiatsos, 1997). The usefulness of such a broad definition of innovation is that it highlights the learning process that takes place at the firm level and its potential role in the development of local technological capabilities and the attainment of competitiveness. But it should be noted that, while innovation and competitiveness are activities of enterprises, success in innovation depends on a wide range of external factors, including the domestic institutional and social environments, national macroeconomic policies, incentive structures, the availability of skills, the local supply base, and the level of investment and linkages. Thus, "innovation management today not only cuts across all stages of production, but increasingly extends beyond the boundaries of the firm. The organization of innovation as a social learning process requires the management of complex interactions with suppliers and users, and with the domestic science and technology infrastructure" (Ernst, Mytelka and Ganiatsos, 1997).

7. In short, the crucial element for enterprise development and competitiveness in a rapidly changing global economic environment is the ability to adjust to new market conditions, identify new opportunities, induce innovations within the enterprise that can exploit these opportunities and minimize marketing and technology development costs through networking and

forging ties with other firms. This implies that the enterprise should have a strategic planning capability. However, as the experience of the East Asian economies has shown, firm-level strategy is a necessary but far from sufficient condition for enterprise development. There is also a need for a coherent policy environment which links the macro and sectoral policies with firm-level efforts to attain and maintain competitiveness and which is conducive to the development of an "innovation system".

## II. NATIONAL DETERMINANTS OF ENTERPRISE DEVELOPMENT AND COMPETITIVENESS

### A. Diversity among firms and national systems

8. Enterprise development (ED) is a **complex process**, influenced by a large number of factors; so is the competitiveness of a country at the firm level. In each country, firms are different in terms of their stage of evolution, size and other characteristics. In their development, firms go through stages of "starting up" (entry and capacity creation), "keeping up" (efficient management and operation of existing capacity), and "growing up" (expansion). While firms often start with production for the domestic market, in the process of expansion they may also consider exporting, which is obviously necessary for their integration into the world economy. Which of these aspects dominates in a specific country depends on its level of development in general and its level of industrial development in particular.

9. Further, the **national environment** in which firms operate varies among countries in terms of the structural characteristics of the country, the degree of development of their markets, their institutional framework, the strength of their infrastructural and human resource base, the quality of government policies, including the degree of policy autonomy, the quality of government-private sector relations and the consistency of macroeconomic, sectoral and firm-level policies from the perspective of the development of competitive enterprises. International competitiveness among firms is in fact significantly influenced by the national environments in which firms operate. While all developing countries have some common problems in ED, least developed countries (LDCs) face additional difficulties. Similarly, economies in transition have their own special features. This is particularly true of manufacturing firms, which are the main focus of this document. 3/

10. In the following section, a number of specific constraints are discussed. Many of these can be addressed by judicious policies and actions initiated by Governments taking a holistic view of the enterprise development process.

### B. Factors and constraints affecting enterprise development

11. For their creation and operation, firms draw on both factor and product markets. In the **factor market**, firms look for finance, skilled and unskilled manpower and technology. In the product market, a firm competes with other firms for market shares. While the market and its development are essential for the operation of firms, the market alone will not be sufficient for the smooth operation of firms. For newcomers to a field, even if the capital market is developed, equity financing is not easy because they represent a higher risk than the established firms due to the lack of information on their

profitability. As a result, under-investment may occur even if the investment in the field concerned is socially desirable, i.e. the social rate of return on investment exceeds the private rate of return. Financing through the banking system also involves similar risks. For the established firms, under-investment in certain activities, such as R & D, knowledge and skills, may also take place since they are highly risky activities.

12. While **shortage of finance** could affect all firms, it is particularly constraining for small and medium-sized enterprises (SMEs) and firms in LDCs. SMEs face basically two major problems in the area of finance: the mobilization of start-up capital and access to working capital and long-term finance for their development. While the initial investment for an SME start-up comes overwhelmingly from personal savings, including those of friends and relatives, and from the informal financial sector, these sources are often inadequate for the financing of subsequent capital investments that would allow an SME to capitalize on growth opportunities. Thus, finance from the formal financial sector becomes a necessity. Where access to formal financial institutions is limited, the expansion of SMEs is seriously compromised. For example, the lack of finance and of information on sources of finance for investment and working capital has been a contributory factor in the closure of some small plastic manufacturing firms in Nigeria (Mambula, 1996).

13. Risks related to viability and lack of dynamism on the part of SMEs, as reflected in high failure rates and high susceptibility to market changes and economic fluctuations, are important factors explaining their lack of access to formal finance. SME entrepreneurs often do not have adequate information and understanding of borrowing procedures to obtain loans in the formal financial sector. They also often lack needed managerial capabilities such as skills in the assessment of input costs, preparation of business plans and proper maintenance of accounts that are formal preconditions for successful credit applications. Inability to provide the required collateral and security or to provide adequate documentation or a bankable project tends to exclude SMEs from the formal financial sector. Further, formal financial institutions tend to discriminate against SMEs, inter alia because of the high transaction costs in relation to the loan amounts. Another factor is their involvement in subsistence activities, for which commercial markets have not yet developed, and it is therefore difficult for banks to assess the commercial risks involved. On the other hand, small-firm entrepreneurs are reluctant to approach financial institutions because of distrust with regard to disclosing information and sharing ownership.

14. **Scarcity of appropriate skills** is another factor constraining firms. SMEs, for example, often face difficulties in areas such as project execution, pre-investment studies, management consulting, production management, product development, marketing, engineering design, quality control, laboratory testing, packaging, accounting, insurance, banking, legal services, repair, maintenance, data management, computer and software, telecommunications and transport. To remedy the situation, training is essential. Some firms, however, are reluctant to bear the cost of training, particularly if the process is lengthy and if there is a risk of the departure of trained labour to other firms (the problem of externality and free riders). The Government may need to compensate for such a market failure by supporting the development

of appropriate training programmes and by phasing in user fees when the value of such programmes is recognized. Training programmes developed by international organizations include EMPRETEC, jointly managed by UNCTAD and the UN Department for Development Support and Management Services, aimed at fostering entrepreneurial development and providing promising entrepreneurs with training in basic business procedures and contacts for enterprise networking.

15. **Size** is also a constraint, since SMEs have greater difficulty than larger firms in generating sufficient profits for reinvestment in growth and in capacity-building. To the extent that their access to information and "best practices" and their ability to finance technological change through the modification of processes and products are also limited, SMEs face added difficulties not only in catching up but in keeping up with global competitors.

16. In the **product market**, competition among firms producing the same product, or close substitutes, can differentially affect a firm's performance, depending on the structure of the market and the nature of the competition policy pursued. The presence of competitors, for example, can provide a stimulus that leads to an improvement in a firm's performance. Conversely, competitors can exercise market power through a variety of restrictive business practices, thus unfairly undercutting rivals. Moreover, in developing a specific industry, the size and composition of domestic demand is also important because it allows benefits to be gained from economies of scale, thus facilitating competition with established firms in the industry where such economies are significant. It is for this reason that, in an industry, import substitution is sometimes regarded as a step towards export promotion (Krugman, 1989). One may argue that the international market would compensate for the small size of the domestic market. It should be mentioned, however, that new domestic firms often lack the necessary experience and support services, particularly marketing and distribution channels, for penetrating international markets.

17. This can be and, in the dynamic Asian economies, has been overcome through international subcontracting. A problem here, however, is the quality of domestic output. The higher the quality demanded by domestic consumers, the closer it is to the requirements of consumers in the international market (Porter, 1990). To improve the quality of domestically produced goods, standardization and quality control are important requirements. This may require the creation of special facilities currently lacking in many developing countries.

18. The **lack of suppliers** in related and supporting industries which could provide the necessary inputs is another important factor constraining the creation, operation and competitiveness of a firm in an industry, particularly at an early stage of industrialization in a developing country. A group of industries linked with each other provides externalities through "linkages" and "learning" effects. For example, the contribution of supplier industries could take the form of the provision of efficient, rapid, low-cost and sometimes preferential access to inputs. The existence of similar and supporting industries also provides opportunities for information flows, distribution channels, and technological know-how available in those

industries (Porter, 1990). Moreover, it intensifies competition, resulting in better product quality and lower prices. Inter-firm relations may be established through the market, cooperative agreements, trade associations, etc. (Best, 1990).

19. The inadequacy of **institutions and infrastructure** is another constraint. Institutions in this regard include both rules and regulations governing economic activities and organizations which implement them, as well as organizations which provide the necessary supporting services. They include the financial system, the marketing network, training facilities, R & D institutes, standards and standards organizations, the stock exchange, property rights institutions, etc. The combination of institutions and infrastructure (transport, communications, water supply, power) facilitates the working of market mechanisms. On the other hand, the lack or inadequacy of these institutions and infrastructure, as in many developing countries, increases the cost of production, lengthens the delivery time and reduces the reliability and credibility of a firm in both domestic and international markets.

20. In addition to institutional and infrastructural factors, a number of other factors limit **entry into international markets**. These include economies of scale in such industries as automobiles, tractors, steel and farm machinery, as well as product differentiation (Clarke, 1989). Technology is an important factor limiting the ability to export, particularly at the early stages of industrialization. However, some SMEs, particularly through the development of production capabilities permitting high-quality output and a process of continuous innovation in products, have succeeded in penetrating export markets. Two good examples include the clothing industry in the Republic of Korea (Mytelka and Ernst, 1997) and the machine tool industry in Taiwan Province of China (Desai, Lautier and Charya, 1996).

21. A range of **government policies** influences the behaviour of firms directly or through the market, institutions, infrastructure and inter-firm relations. These policies include firm-level intervention, industrial and sectoral policies, interventions in the market, such as competition policy and trade policy, and above all macro policies, whether autonomous or through SAPs. Such policies may facilitate or inhibit the entry of firms into an industry and their operation and growth. Many of these policies will be dealt with later in chapter III. Here, attention is focused on legal, regulatory and tax policies.

22. Regulatory requirements can discriminate inadvertently against SMEs. This can occur, for example, where private entrepreneurs are prohibited from engaging in economic activities reserved for State monopolies. It was most notable in the case of agricultural marketing boards for cash crops, particularly in African developing countries, which eliminated opportunities for SMEs to engage in the marketing and distribution of agricultural inputs and outputs, a sector where such firms might have emerged in the 1970s. However, even in sectors that are open to SMEs, the legal, regulatory and tax environment can be so complex and impose such a disproportionately high cost on SMEs that it becomes a major impediment to the successful start-up and continuation or expansion of many small businesses. Dealing with such an environment is particularly burdensome for SMEs. Such an environment may also

discourage informal sector enterprises from entering the formal sector. It may also serve as an impediment to exporting, as in Ghana (Acheampong and Tribe, 1996). Some countries have adopted specific measures to address some of these problems. For example, in India, small enterprises are not required to file an income tax return. After paying a stipulated amount of Rs. 1,400, they are free from any inquiry from the income tax authority (Chee, 1995). In Ecuador, microenterprises are encouraged to register by the granting of certain advantages (special loans, special provisions for the workforce, etc.) in return for paying taxes. Further, those microenterprises unable to pay taxes may be exempted from doing so (Morrisson, et al., 1994).

### C. Particular problems of LDCs

23. Although the constraints of enterprise development are common to most developing countries, the problem seems to be particularly severe in the LDCs. Most enterprises in LDCs are still in the rudimentary stages of development, and so are their factor and product markets, basically because of their **weaker structural features**. More than other developing countries, they lack the capital, infrastructure, institutions, skills and organizational and innovative capabilities necessary for catching up.

24. LDCs have low incomes, small domestic markets and narrow export bases and depend on imported inputs in a situation of acute foreign exchange scarcity exacerbated by high external indebtedness. The markets of LDCs are small because of low levels of per capita income, small population size or a combination of both. From the start, therefore, the size of the domestic market imposes limits on enterprise development and on the degree to which local enterprises can accumulate technological capability and a knowledge base through the process of technological upgrading, growth and competitiveness in the domestic market. The deterioration in their terms of trade since the early 1980s has diminished their capacity to obtain technology and other inputs from abroad. LDCs also suffer from an extremely limited internal savings capacity and underdeveloped financial markets, geographical disadvantages (as in the case of many land-locked and small island LDCs), inadequate infrastructure, poor communications and low education levels which are reflected, inter alia, in weak managerial and administrative capacity and in a severe shortage of skilled and trained manpower. These factors, as well as political instability in some LDCs, have also served to constrain the inflow of foreign investment. Further, many enterprises of LDCs have suffered from the negative impact of SAPs in recent years.

25. In general, the limited evidence available suggests that enterprise development - as measured by investment in learning, technological adaptation and assimilation, product and process innovation and the capacity to adjust to new market conditions - has been limited and that LDCs' enterprises, especially in the manufacturing sector, are ill-equipped to take advantage of the opportunities arising from a more liberal domestic and international economic environment and thus to cope with the challenges to development and competitiveness posed by these changes. 4/

26. Most enterprises have been established in the traditional sectors, such as food products, beverages, textiles and leather products, simple processing (for example, industrial chemicals) and assembly activities. Very few LDC

enterprises have been engaged in capital goods or even intermediate goods production. Secondly, the enterprise sector in these countries has a dual structure where, at one extreme, there are a few large modern capital-intensive, resource-based, import-dependent and assembly-oriented enterprises, with the ability to produce to international standards though not necessarily at competitive prices, and, at the other extreme, there are small and informal sector enterprises with very simple and traditional technologies serving limited local markets and lacking standardization, quality control and modern management techniques. 5/ In many LDCs, there are few, if any, enterprises in the middle range, and this "**missing middle**" has implications for the growth opportunities and potential of small and informal sector enterprises.

27. Most of the enterprises in the first category are either foreign-owned or in the public sector. Regardless of their ownership, however, these enterprises tend to have strong linkages with foreign suppliers rather than domestic firms. The involvement of local private investors in these enterprises is a recent phenomenon due mainly to indigenization and privatization programmes. Moreover, because of the small size of the market in many LDCs and the fact that the demand for manufactured goods tends to originate from the urban elite "whose tastes had been shaped by imports", the manufacturing activities that have emerged have tended to be "import-reproducing" rather than "import-substituting" (UNCTAD, 1990). By reproducing instead of substituting, local firms have not only perpetuated their reliance on foreign technology, design and skills; they have also maintained an operation "almost void of demand for technological change and innovation" (ibid.). In contrast, the small and informal sector enterprises are locally owned and consist of the bulk of the private sector in these economies. They are geared to meeting local demands for simple, low-cost products, using very little equipment and skills that can be acquired locally.

28. With the decline of the modern sector in recent years, **informal sector enterprises** have acquired greater importance as suppliers of basic goods and services and generators of employment and income. This is particularly true in sub-Saharan Africa, where the informal sector employs approximately 60 per cent of the urban labour force, equivalent to about 15 per cent of the regional workforce. In the urban areas, this sector employs more people than the modern sector and provides higher income than the rural sector (ILO, 1991). Thus, the informal sector is not a transitory activity, as assumed in the 1970s, where the urban unemployed and rural migrants obtain temporary employment before moving on to the modern sector, but has become a permanent feature and an important means of survival for a large proportion of the urban population.

29. The question, however, is whether informal sector enterprises in LDCs can serve in the long run as engines of economic growth, enterprise development, innovative capability-building and international competitiveness. While such enterprises, essentially microenterprises, serve a useful economic and social role in the short run, what is required in the long run is to support their growth and graduation into the formal sector. There are huge obstacles to this process, emanating from the enterprises themselves and from their lack of access to such essential inputs as finance, skills, management and information on markets. Due to the informal nature of their activities,

such enterprises are often denied access to investment finance from formal private capital markets, public funds, development banks and other financial institutions. A coherent programme is therefore needed, as part of an enterprise development strategy, to develop a critical mass of domestic enterprises in the middle range, including through the **growing of enterprises** - from micro to small and from small to medium-sized. Such a programme will need to include the provision of infrastructure, information, finance, training and other business support services particularly targeted at the micro- or informal sector enterprises and taking into account the needs of women entrepreneurs. It is recognized that such a process takes time but a concerted and determined effort, together with strong international support, is needed if LDCs are to succeed in building up the necessary enterprises for their integration into the world economy. It is also particularly important that structural adjustment programmes (SAPs) facilitate this process.

### D. Impact of structural adjustment programmes

30. SAPs contain four main elements - trade liberalization, compensatory devaluation of the national currency, expenditure reduction through monetary and fiscal policies, and privatization and reform of public enterprises. As far as their impact on ED is concerned, they suffer from two main problems: they are universal and uniform. Universality means that they contain a package applied to all developing countries irrespective of their needs, level of development and industrialization and specific structural features. Uniformity means that the same degree of incentives, e.g. a nominal tariff rate, is applied to all sectors, industries and firms. In fact, SAPs do not take into consideration problems of enterprises in specific countries and industries.

31. SAPs have produced **mixed results**, depending on the conditions of the country concerned and the speed with which they have been applied. As regards their impact on the industrial enterprises of LDCs in particular, a study of the recent experience of five sub-Saharan African countries shows that, in some sectors, there are enterprises with the capability to adjust to the new competitive environment, particularly those run by "dynamic, better educated, profit-motivated entrepreneurs" who focus their firms on "niche markets". (Parker et al., 1995). A recent study on Bangladesh also highlights the sectoral differences in the impact of adjustment programmes, noting the growth of exports of leather goods and clothing following the introduction of macroeconomic policy reforms in the 1980s (United Nations, 1995). However, such success stories are the exception rather than the rule in LDCs.

32. If one concentrates on trade liberalization and devaluation, the two main tools of SAPs which affect the performance of firms directly, one finds that there is no clear and systematic association between trade liberalization and devaluation, on the one hand, and growth and diversification of output and exports on the other. Moreover, a number of countries have experienced **de-industrialization** following the implementation of SAPs (UNCTAD, 1993). In Ghana, for example, the devaluation of the cedi between 1983 and 1994 caused severe cash-flow and liquidity problems for industry; large numbers of workers were laid off, leading to a general reduction in purchasing power and hitting SMEs particularly strongly. A substantial market for imported second-hand goods emerged and a "dumping" of finished goods on the local market took

place. The textile and garments industry was one of the hardest-hit sectors, and the manufacturing production indices suggest that the 1992 output levels were only 22 per cent of the 1977 levels (Boch-Ocansey, 1995).

33. Although the liberalized import of inputs, together with increases in the supply of foreign exchange made available through SAPs, have led to some expansion in output and even exports in the short run, the expansion was not often sustained in the long run, mainly because of the lack of response by private enterprises in terms of investing in production capacity due to increased interest rates and uncertainties regarding the economic prospects of the countries concerned (Jenkins, 1996, Moseley, 1993 and Moseley et al., 1995). SMEs in Ghana, for example, which constitute some 95 per cent of the registered companies, were not able to take full advantage of the deepening of financial markets due to financial sector reforms because of high interest rates of 30 per cent and above, high financial intermediation costs averaging about 8 per cent, and lack of assistance in accessing information or in the packaging of proposals and other documents into acceptable formats.

34. In most cases, where there was some export expansion, it was based on simple processing and traditional manufacturing activities. Firms did not attempt any significant upgrading due to the lack of capital for investment, skills and the institutions needed to help enterprises develop those capacities. This is the case even in Ghana, which is often regarded as a successful adjusting country (Lall et al., 1994, Acheampong and Tribe, 1996).

35. Finally, the negative impact of trade liberalization as been felt more severely by SMEs than by larger firms. Many SMEs were unable to survive because of premature and sudden removal of protection and devaluation. Devaluation, as a uniform policy tool, increases the cost of imported inputs on which many industrial firms depend, in addition to the increase in the cost of credit already mentioned. At the same time, trade liberalization subjected them to import competition before they were able to develop their capabilities, leading to plant closures and expansion of the informal sector. For example, in Kenya, while the formal manufacturing sector declined, the share of the informal sector in total employment increased from 18 per cent to 27 per cent between 1986 and 1992. In fact, the lack of opportunities in the formal sector in general has been the cause of the growth of the informal sector in a large number of African countries, partly as a result of the implementation of SAPs (Schulz, 1995, for the case of the United Republic of Tanzania, and Boch-Ocansey, 1995, for Ghana).

36. There is some evidence that when countries have liberalized their import regimes selectively and gradually, however, the response of industries and firms in terms of expansion of output, export and investment has been more positive. This is true of a number of LDCs in Asia, such as Bangladesh and Nepal during the 1980s and early 1990s (UNCTAD, 1993). It has also been the case in East Asia. For example, the Republic of Korea embarked on a liberalization of the imports of most of its light manufacturing products during the 1970s and early 1980s after they reached a stage of maturity following infant industry protection which began in the early 1950s. At the same time, it left the rate of protection for its heavy industries, introduced in the late 1960s and early 1970s, unchanged, and in some cases even increased it.

37. The **timing and sequencing of liberalization policies** has also been important as far as their impact on innovation is concerned. For example, in the case of the petrochemical and telecommunication industries of the Republic of Korea, before opening the markets to foreign competition, the Government started a process of domestic reform and deregulation, thus pushing local firms to break their past habits and practices. Moreover, even when tariff reduction was introduced, it was implemented gradually. By contrast, in the case of Brazil, a radical deregulation and rapid market opening subjected the local firms concerned to sudden competition with foreign companies. Consequently, the ability of small independent firms to innovate was decreased (Chesnais F. and Kim, 1996, Mytelka and Ernst, 1997). The important question of the impact of the nature of policy reforms, their speed and sequencing will be taken up again in chapter III.

## E. Particular issues concerning economies in transition

38. While enterprises in economies in transition suffer from many of the problems identified earlier in respect of developing countries, in some aspects the magnitude of the problems confronting them is greater. For example, contrary to market economies, at the beginning of the transformation process, the overwhelming majority of enterprises in countries in transition were State-owned enterprises (SOEs). In this context, **enterprise reform** was essential for sustainable long-term economic growth. Accordingly, privatization and enterprise restructuring have been an important part of micro-economic policies in economies in transition. A second equally important element is encouraging the setting-up of new firms.

39. It should be noted, however, that economies in transition are also far from being homogenous, reflecting differences in levels of economic development, enterprise culture, infrastructural and educational base, pre-communist economic and social patterns, geographic location and most of all the degree of the use of market mechanisms prior to the change in their political systems.

40. Generally speaking, three main issues stand out concerning the economies in transition as compared with developing countries, namely the size and speed of the privatization process, the development of firms and markets and the creation of institutions, and changes of business habits inherited from the previous political system.

41. The ongoing process of privatization and restructuring and of opening up their economies to international markets and foreign competition has already contributed to the development of product and factor markets, although much remains to be done. One important problem is that the continuing State control of the banking system, coupled with cross shareholdings between banks and enterprises, often gives rise to credit allocations on political rather than on commercial grounds. It has led in some instances to collapse and insolvency of banks, as exemplified by the recent collapse of Kreditni Banka and similar problems faced by Agrobanka in the Czech Republic.

42. In the development of markets and firms, the focus of policy makers has shifted increasingly to the new, rapidly growing SME sector. Since, before the transition, the SME sector was by and large underdeveloped or in many

instances did not exist at all (with the exception of informal activities), the enterprise behaviour of the nascent SMEs is not marked by planned-economy habits and practices. However, many **obstacles to SME development** remain. Persistently high inflation and interest rates have been among the most pressing problems in most transitional economies, as, for example, in the Russian Federation (Pissaredis et al., 1996). Other constraints include lack of inter-firm linkages, unreliability of suppliers, obsolete technology and old machines, and high taxes and social insurance contributions. With respect to the legal and regulatory framework, administrative regulations are complicated and regulatory shortcomings and contradictions in the legal system abound. This leads inevitably to excessive regulation, arbitrary administrative decisions and weak enforcement of contracts. Some of these obstacles were inherited from the old command system. Others are a consequence of new legislation and administrative reforms, initiated without analysing the impact of the new laws and regulations on the private sector and on SMEs in particular.

43. What is particularly lacking in terms of raising domestic competition and increasing the competitiveness of economies in transition is a sufficient number of privately owned medium-sized enterprises capable of growing and competing not only in domestic markets but also in foreign markets. Thus, the main lesson learned to date indicates that, while promoting new small enterprises may have helped to create a thriving SME sector, it has not so far created a sufficient mass of vigorous and innovative medium-sized enterprises capable of becoming a driving force for a healthy market economy.

## III. KEY ISSUES RELATING TO AN ENTERPRISE DEVELOPMENT STRATEGY

### A. Introduction

44. The above discussion has highlighted a number of important features of the changing enterprise world and the nature of international competition brought about by globalization, liberalization and technological advances. It has pointed in particular to the need for firm-level ability to innovate and to adapt in order to become or remain competitive and the importance of linkages to dynamic domestic industrial sectors and other economic actors - domestic and foreign - in this process. This section raises a number of issues relating to the wide range of policies and practices which developing countries have used to overcome the constraints and to take advantage of the new opportunities offered by these changes. It points to possible areas for future work.

### B. The role of the State

45. The Government has the power to establish the right macroeconomic environment, as well as a transparent, stable and predictable legal, regulatory and tax framework, and thus create favourable conditions for entrepreneurial and enterprise development. By acting as a **catalytic or intermediating agent**, including through appropriate policies and a supportive business infrastructure, it can stimulate, facilitate or support the development of enterprises, particularly SMEs, and of inter-firm cooperation, both internally and with foreign firms. By developing the necessary physical infrastructure and skills, including in cooperation with the private sector,

as well as adopting appropriate policies, it can promote innovative capacity and structural change in the economy. In addition, together with other Governments, it can help to promote regional cooperation, for example through the networking of SME support agencies, in order to undertake joint activities and to pool resources, for example in the area of business support services, as well as to foster inter-firm cooperation.

46. The question arises as to whether the Government should intervene in support of ED or whether ED should be left entirely to the operation of market forces. The main argument against **government intervention** is that resource allocation by the market will also serve the overall interests of society. While there is a risk of market failure, it needs to be weighed against the risk of government failure. Accordingly, the Government's role should be confined to its core functions, namely creating a sound legal and macroeconomic framework, protecting the environment, ensuring order and security and providing infrastructure, education, social protection and essential public services.

47. The arguments in favour of intervention are made on both theoretical and empirical grounds. The theoretical argument is that, even if the market were efficient in its allocative functions, it may fail in its creative functions, particularly in developing countries at early stages of their development. While efficient allocation of resources is important, equally important is the expansion of the existing capacity, i.e. growth through the expansion of the available resources. Further, historically, the State has played an important role, directly and indirectly, in industrialization in all the early and late industrializing countries. The nature and degree of intervention has varied from one country to another. For example, intervention was more extensive in the latecomers than in the other countries. But, in practically all countries, from the United Kingdom to the United States, Germany and France, and more recently the East Asian countries, the degree of intervention in international trade has been more pronounced than in other activities. Even today, commercial diplomacy is an important part of the political and economic activities of many countries.

48. If government intervention is accepted, the question arises as to whether such intervention should be **functional or selective,** i.e. whether the Government should provide incentives for all sectors and industries on a uniform or a selective basis. The argument in favour of uniformity is that it is simple to implement and reduces the risk of corruption, since the market will act in a uniform fashion. Moreover, since in many developing countries the capacity of the Government to design and implement policies is limited, selective intervention imposes further burdens on the Government and increases the risk of government failure, which could be higher than the risk of market failure.

49. The arguments in favour of selective intervention are numerous. The most important one is that, in practice, hardly any policy instrument can be neutral. In trade policy, for example, a uniform tariff rate on all sectors and industries implies different effective rates of protection for different industries, depending on their import intensities, resulting in a bias against industries with higher import intensities. The latter are usually the modern manufacturing industries which produce for export rather than for the domestic

market. Similarly, a uniform (high) interest rate applied to all industries and firms would penalize those firms in need of high levels of working capital. Moreover, other things being equal, it would be biased against smaller firms, as opposed to large ones. This is so because the latter have a higher capacity not only for taking risks but also for self-financing and raising funds in capital markets for investment purposes. Further, uniformity of incentives may in certain circumstances involve negative externalities. For example, in trade policy, when a low uniform tariff rate is applied to all products, any extra amount spent on luxury goods deprives the industrial sector of scarce foreign exchange.

50. Another argument in favour of selective intervention is the need for "inducing the decision-making opportunities" (Hirschman, 1958). Since there is a lack of "investment decision opportunities" at early stages of development he argues, investment in strategic industries provides a stimulus to other industries through their forward and backward linkages. The lack of investment decision opportunities is basically due to a weak industrial structure and low level of demand. Considering the scarcity of resources, investments in these strategic industries are thus preferable because they provide externalities. In other words, the benefits of these industries for the society as a whole exceed those for the private investors. Finally, the argument concerning the risk of government failure is not an argument against government intervention. It is rather an argument for strengthening the capacity of government officials by training and learning by doing.

51. The question of the selectivity and uniformity of the incentives structure also has implications for the **choice of policy tools**. For example, it is sometimes argued that while devaluation might serve other purposes, it is not necessarily a good policy instrument for promoting industrial expansion in developing countries. Devaluation results in uniform price changes over the whole range of tradeable goods rather than for a selected number of products. The supply response to prices is much lower when all the outputs of a sector are equally affected; it is stronger when relative prices affect only one good or several goods (Streeten, 1987). Even in industrial countries, there is some evidence that reallocation of resources from non-tradeable sectors, and within tradeables from importables to exportables (and in the latter from traditional to new products), might be more responsive to targeted incentives such as subsidies than to exchange rate adjustments. Moreover, in the particular case of SMEs, a recent study of five African countries has recommended the use of incentives targeted towards dynamic enterprises (Parker et al., 1995).

52. Another important question is the **speed of reform**, i.e. whether it should be introduced as shock therapy or gradually. This issue was touched upon earlier with regard to the impact of SAPs on LDCs' enterprises, but it is also relevant in the case of economies in transition. The main argument in favour of shock therapy is that it gives a clear picture of the Government's intentions. However, its implementation often faces problems, since the market can accommodate gradual and marginal changes more successfully than sudden major ones. Moreover, the advantage of a gradual process of change is that the changes can be sequenced in order to produce a more efficient outcome than would otherwise be the case, as indicated earlier in the case of market opening (see chapter II. D).

53. Another issue concerns the role of **competition policy**, which is related to a number of other factors including trade policy and the type, size and objectives of enterprises. The weight given to various types of enterprises, as well as the optimum degree of competition at any point in time, or over time, would depend inter alia on the objectives of development and industrialization. With respect to the types of enterprises, one may distinguish between informal sector enterprises, essentially microenterprises, and enterprises in the formal sector, which include some microenterprises, SMEs and large firms. As regards microenterprises in the informal sector, the low barriers to entry lead to intense competition, while impeding the enterprises' growth. Although they are important means of survival and employment creation, these enterprises contribute little to exports. In fact, there is some evidence to show that the informal sector cannot be a dynamic one in the process of development in the long run (Marsten 1987). On the other hand, it has been argued that, despite all its shortcomings, the informal sector is a good channel for business start-ups in a situation where there is a chain of deficiencies affecting ED. It can act as a catalyst in the transition to the formal sector for the development and growth of microenterprises into SMEs.

54. Linked to the issue of market concentration, licensing and competition is also the question of economies of scale. The issue is to what extent the market should be competitive in the traditional sense of the word, i.e. marked by the absence of regulatory barriers to entry and the existence of small production units, etc. One option is not to have any regulation or intervention. However, when some form of competition policy is required, the question also arises as to what needs to be done over the course of industrialization. One argument is that, at an early stage of development when the risk of investment is high, licensing and infant industry protection create some monopoly rents for the investor(s), compensating for those risks. The counter argument is that, while this policy favours producers, it is harmful to consumers. Nevertheless, since the development of long-term capacity is an important objective, some short-term loss by consumers is inevitable. Moreover, as soon as some production capacity is developed, domestic competition may be stimulated by allowing entry of other domestic firms into the industry. Subsequently, as the industrial base of the country in the industry concerned is developed and capabilities are acquired, the domestic sector may be exposed to import competition through gradual trade liberalization. However, the exact nature and evolution of competition policy in each country and industry has to be examined closely.

55. An issue related to the size of operation (plant and firm) is **innovation**, i.e. whether larger firms are more innovative than smaller ones. Given that firms at early stages of their development lack R & D capacity, the question also arises as to the extent to which the Government should support R & D activities through public and private research institutes. Once again, the situation should be examined more closely in each country/industry case.

56. The question of **ownership** - public, private and foreign - also requires attention. The balance between them is to be determined by the country's stage of development, the level of development of its domestic enterprises and the objectives of government policy in respect of particular sectors, such as strategic industries or essential public services. In some cases, because of

the high sunk costs, the Government may have no choice but to undertake the necessary investment, but even enterprises in industries considered to be strategic by some countries, such as telecommunications, can be corporatized, partially privatized and subjected to private sector disciplines and competition in order to enhance their performance.

57. Another important issue is **policy coherence**. This implies not only the design of coherent policies but also clarity and consistency in their implementation, as well as the need for an adequate response by the private sector (Henley and O'Neill, 1996, Mytelka, 1996, Lall et al, 1994). Thus, among other things, policies which have a bearing on entrepreneurship and the development of enterprises, such as monetary, fiscal, trade and exchange rate policies, will need to be consistent with sectoral and firm-level policies. For example, since macroeconomic policies to achieve stability through high interest rates or to promote competition through trade liberalization may be damaging for SMEs, careful tuning and timing of such policies may be necessary if policies to support the development of SMEs are not to be undermined. At the same time, support programmes for SME development need to be properly designed and contribute to productive activities, so that they will be fiscally neutral and not undermine macroeconomic stability. Similarly, without creating business and consumer confidence by restoring fiscal control, the use of incentives to stimulate entrepreneurship and business start-ups may not be enough. Further, measures of liberalization and structural adjustment may be inimical to enterprise development and survival if domestic enterprises are not given time to adjust, together with measures to facilitate their adjustment, including access to essential inputs. Moreover, measures to facilitate structural change are necessary, including the development of infrastructure and of skills, if structural adjustment and liberalization are to lead to such change and thus to enhance the ability of firms and sectors to innovate and to adapt.

58. There is also need for ensuring coordination, coherence and complementarity in the design and implementation of instruments for enterprise development. For example, adopting programmes to enhance the access of SMEs to essential inputs, including finance, machinery or imported components, will not be sufficient if there are no accompanying measures to help SMEs to obtain or use those inputs, including assistance in the preparation of viable loan requests or in the running of the machinery or the provision of access to foreign exchange.

59. The above discussion has highlighted the need for further research on a number of issues including: the design and implementation of enterprise development strategies; promotion of innovation and competitiveness of firms in both domestic and international markets; policies and institutions for the growth of microenterprises, including the role of the legal, regulatory and tax environment; and government policies and firm-level strategies to allow firms to move from domestic production to export markets. Such research will need to examine the respective roles of the State and private sector actors, both domestic and foreign, and draw lessons from case studies in order to identify "best practices".

## C. Government-private sector relations

60. The nature and quality of government-private sector relations and policy dialogue help to define the Government's role as a **partner to the private sector** in promoting innovation and developing enterprise competitiveness and as a mediating agent in balancing and resolving different "claims" of various economic actors and reconciling them with the objectives of government policy.

61. Various mechanisms have been established by Governments for the promotion of government-private sector policy dialogue. Perhaps the most structured among them are government-business deliberative or consultative councils established by Governments in various East Asian countries, including Japan, the Republic of Korea, Malaysia and Thailand. Such mechanisms have served as useful forums for exchanging information and for obtaining inputs for policy-making, including in the areas of education and technological capacity-building, from the private sector on such matters as market trends and new production possibilities, industrial restructuring and competitiveness, technological developments, R & D projects and business regulations. The consultations may be organized on a functional basis (for example, on pollution, finance or taxation issues) or relate to industry-specific or sectoral issues (for example, automobiles, consumer electronics or chemicals).

62. Such consultative mechanisms serve a number of useful purposes. They establish the **broad parameters for government-business cooperation** and thereby create transparency and a climate of confidence. If clear rules are established for an industry, members of the industry can concentrate on market competition and not be concerned about others trying to curry special favours from the Government. By exposing government officials to the workings of the market place (sometimes accompanied by measures to encourage government officials and business leaders to switch places in government and business executive positions), they help to enhance the enterprise culture in government. They also serve as proto-democratic institutions, providing direct channels for businesses, labour, consumers and academia to the seat of power. Thus, they can help to meet the requirements for successful implementation of government policy, including policy consistency, popular acceptance and private sector support. Such consultations have produced important results in terms of promoting industrialization and a government-private sector partnership.

63. For such a dialogue to succeed, it is especially important that the private sector partners, including SMEs, be well documented and organized. An efficient, professional and impartial bureaucracy is also necessary in order to ensure that the output produced as a result of the consultations commands the confidence of all the parties concerned. It is also necessary in order to avoid the risk of "bureaucratic capture" by large firms or enterprises with strong political connections. Adequate follow-up to the decisions taken also needs to be assured.

64. Such a dialogue may be seen as an important part of the process of developing and implementing a strategy for enterprise development. Since the private sector operates in a dynamic context and the Government's role itself may evolve in response to changing circumstances and requirements, the

dialogue provides a forum to address the changes in a flexible and concerted manner and to formulate a proper response that enjoys the support of both the Government and the private sector.

65. Given the many areas where there is a **mutual interest** in **government-private sector cooperation**, including, for example, skills, technological and infrastructure development, environmental protection and the promotion of inter-firm backward and forward linkages, the ability of the Government and the private sector to build up a confident and effective working relationship with each other assumes a particular importance. The quality of such a working relationship might be a competitive advantage for a country in its own right in a globalizing and liberalizing world economy. In fact, it has been suggested that, in an increasingly interdependent world, competition among enterprises is often competition among different systems of government-private sector relationships (Irfan ul Haque, 1991). Further research on the conditions underlying how various forms of government-private sector relations, and their institutional mechanisms, have developed and the lessons that can be learnt from them is needed.

### D. Size of enterprises, networking and clustering

66. There is no unique or universal recipe for the spatial or organizational arrangements that best fit the needs of different enterprises or apply across time and space. The widespread incorporation of information technology in production and communications has considerably reduced the physical size of factories (by increasing the versatility of machines, thereby lowering the number of machines required for different sequences of operations), expanded the variety of jobs that can be performed, and improved the precision in production and quality control that can be achieved by a worker, and (through instant information connectivity) greatly enhanced intra- and inter-firm spatial networking to maximize location-specific advantages. Notwithstanding all such progress, the **optimum size** of an enterprise necessarily varies with the specific production activities or sector in which the enterprise operates. There is, in addition, a minimum (economic) scale dictated by the fixed costs of modern establishment and operation; some such outlays, those for state-of-the-art equipment and provisions for its maintenance, are generally not inconsiderable.

67. For developing countries in general, SMEs have certain advantages over large firms - as regards, for example, more appropriate factor intensities, employment generation, and appreciable flexibility in labour use and job demarcation. But they also suffer from several weaknesses - including, as indicated in chapter II, limited access to external finance plus limited internal resources, low-level technologies, weak marketing capabilities and lack of flexibility and capacity to cope with unstable or changing demand.

68. Two important issues relating to size emerge in this context. Firstly, through internal economies of scale, 6/ large enterprises in some industries enjoy a cost advantage over SMEs. Secondly, "unorganized" and "unintegrated" SMEs often fail to fully exploit dynamic external economies of scale. 7/ These, however, can be reaped through skill formation and upgrading, a diffusion of improved technologies, and incremental process and product innovations via an inter-firm networking and integration nexus. For example,

a stable **vertical or horizontal subcontracting arrangement** between large and small businesses in the domestic environment can provide complementarities and widen the scope for increasing returns of scale and scope. 8/ Several countries in East Asia have been relatively successful in inducing such forms of industrial organization through the provision of technical and other support and extension services. In some other countries, SMEs have also been successful in export expansion. For example, SMEs accounted for around 62 per cent of total manufactured exports of Turkey in the early 1990s.

69. Alternatively, **the clustering of SMEs** in specific locations can also generate large benefits. Indeed, such spatial agglomerations of small firms are quite widespread in many developing countries (UNCTAD, 1994). They have often constituted an essential building block of industrial districts in these countries, especially through the consequent aggregation of ancillary support activities - such as trading, storage, transport, repairs, and the provision of environmentally friendly techniques as in the tanning and dyeing industries. Advances in information and communications technologies have also made possible "small-within-big" organizational structures. The advantages of such organizational structures can also be tapped by small firms able to work together to achieve economies of scale and scope through the development of flexible specialization, the sharing of joint equipment and facilities and the creation of inter-firm linkages. Thus, well organized and well connected small firms, such as those in the successful industrial districts, can also compete in the international market place. In fact, with the continuing advances in multimedia technologies and the development of customized products and services, the specialized small firm may even have a comparative advantage in meeting such demands.

70. However, from the limited evidence available, it appears that, for the most part, clusters of small firms have not generated substantial technological dynamism of more than an incremental nature. 9/ Many of these industrial districts are located in labour-surplus regions, employing less well trained labour. The lack of measures to develop such dynamism, spillovers, skills upgrading and technological innovations in many of these clusters is a matter that requires attention in ED policies and strategies.

71. With few exceptions, industrial or artisanal clusters have achieved their existing levels of development with little direct government support. But such clusters may embody the nucleus of an emerging class of entrepreneurs or industrialists, one of the preconditions for sustainable ED in a wider context. The development of an auto parts industry in the Nnewi region in Nigeria provides an illustration of how local entrepreneurs, starting from trading activities, succeeded in establishing a competitive industrial cluster by creating appropriate linkages, both with foreign firms (in Taiwan, Province of China) and with domestic firms, including supplier firms in the areas of smelting, glass making, etc. (Banji Oyelaran-Oyeyinka, 1996)

72. Another relatively new and innovative spatial arrangement is embodied in the linking up of firms in existing or potential industrial clusters or districts within and across neighbouring borders; these production units may be a combination of both SMEs and large enterprises. As a matter of fact, there has been a mushrooming of domestic and external "**growth triangles**", "growth corridors", and "growth quadrangles" inside and among economies in

East and South-East Asia especially. The best-known such arrangement is the Johor-Singapore-Riau growth triangle - encompassing contiguous regions of Malaysia, Singapore and Indonesia respectively. 10/

73. Such spatial configurations of intra- and inter-firm networking and integration constitute another way to concentrate, rather than thinly dissipate, scarce domestic resources (whether these be human, financial or infrastructural in nature) for the promotion of the necessary critical masses and linkages so crucial for maximizing synergies and complementarities among domestic regions, and hence the attainment of dynamic scale economies within countries. They are very different from export processing or special economic zones. Organizationally, these are by and large well demarcated enclaves for trade-related FDI in normally labour-intensive, mature technology manufactures having limited linkages, both backward and forward, to the domestic economy, with the notable exception of their large volumes of domestic employment.

74. By the same token, the collaborative operation of enterprises within multi-nation spatial growth arrangements with whatever geometrical linkages can not only serve as a focal point for the realization of cross-country complementarities in joint production and ancillary infrastructure development, employment generation and skills upgrading, trade and trade-driven FDI, and tourism, but also help to reduce, among neighbouring countries or partner firms, the incidence of counter-productive or wasteful bidding for resources, duplication of infrastructure and investment projects, and incompatibility of trade-based facilities, standards and procedures. Lastly, the pay-offs through greater mutual understanding and confidence gained in subregional economic cooperation and factor mobility may be intangible, but they generate substantial positive, highly visible and collective external benefits for ED, networking and integration among the collaborating or participating countries in the long run.

75. It is clear from the above discussion that the scope, opportunities and options for "positive-sum" collaborative and innovative action at both the enterprise and country levels have widened appreciably along with the upward trends in economic liberalization and globalization and in the diffusion of embodied technological advances and innovations. It is also apparent that, governed by their diverse initial conditions and circumstances, countries have responded to the challenges, as well as benefited from the opportunities, associated with the new "development paradigm" differently.

76. Many issues, however, remain for consideration in the context of ED policies and strategies at the domestic and international levels. One is how to facilitate and sustain the ongoing improvements in enterprise capabilities and competitiveness through various modalities of networking and clustering among firms, regardless of size and/or location. At another level there is the issue of the promotion of enterprise networking and integration, and hence of synergies and complementarities, among the many countries whose economic policy and institutional frameworks still remain widely different at present. A similar consideration also applies to inter-firm cooperation among countries with sharply different technological capabilities and bases; this latter issue assumes additional significance as the threat of further, multi-dimensional marginalization (economic, financial and technological) remains real for a large number of disadvantaged economies, including the LDCs.

77. In addition to these issues, the questions of the appropriate size and organization of the firm and of the scope and possibilities of inter-firm cooperation in order to achieve organizational efficiency and the benefits of cooperation are matters for further research. In this regard, it will also be useful to draw lessons from case studies on the role of public and private sectors in promoting networking and clustering of firms and the factors which may facilitate or hinder their development.

## E. Innovation and technological capacity-building

78. Acquiring technological capacities involves time, effort, cost and risk, as well as complex interactions among firms and between firms and institutions. It further requires a favourable economic, institutional and legal environment, and the availability of such factors as skills and information (UNCTAD, 1995). While for most developing countries this appears to call for increasing and qualitatively upgrading their infrastructural and human resource base, for economies in transition it would seem largely to involve new ways of using existing R & D and technological potential - created for a different economic system - in a way that is more appropriate to market economies and their changing societies. As knowledge, in the form of technology, innovation and, increasingly, information, becomes a powerful "engine of wealth", technological capacity becomes vital for achieving economic development and a major prerequisite for increasing enterprises' productivity and competitiveness. However, experiences from the industrialized countries have shown that investment alone does not pay off in terms of productivity gains if not accompanied by complementary policies creating an enabling environment, as well as an adequate level of cooperation between public and private R & D.

79. Important opportunities for innovation and for upgrading the technological capacity of enterprises can be seen in various **emerging forms of cooperation** among firms and between firms and R & D institutions. These range from informal linkages to "arrangements that are so intricate that one can hardly tell whether the organizations involved are indeed separate" (Badaracco, 1991). For the firms, they involve new relationships among themselves, their customers and suppliers, and even their competitors, forming a dense web of formal and informal relationships. Such arrangements give rise to opportunities for the creation of technology cooperation involving a two-way relationship and a deliberate endeavour to share technological knowledge and to collaborate on R & D, training, manufacturing and marketing, as "companies need to share costs, skills and access to markets" (Ohmae, 1993).

80. First experiences with such new forms of cooperation further show that a number of questions need to be addressed in order to translate such cooperative approaches into a cross-national context, involving the participation of firms from developed, developing and transitional economies (UNCTAD, 1995b, UNCTAD, 1995c, UNCTAD 1996). The emerging trend shows that the options and scope for action at both enterprise and governmental levels have increased considerably over the past decade. It may be timely to set up policy frameworks and programmes to take advantage of these opportunities. There will be a need for policy research with the aim of improving understanding of the interrelationship between technology and enterprise

development, including the issues involved and opportunities offered by cooperative endeavours, as well as modalities for their practical application. This could involve undertaking case studies, as well as studies of specific sectors. Pilot projects could add a new dimension and quality to technology cooperation efforts for enterprise development. Such projects could focus on the combination of elements of international support, innovation and technological capacity-building and private sector development.

## F. Policy implications

81. In a rapidly changing global economic, technological and competitive environment, the critical elements for enterprise development and competitiveness are the ability to adjust to new market conditions, identify new opportunities, innovate within the enterprise and minimize marketing and technology development costs through networking and forging ties with other firms. This implies that enterprises should have a strategic planning capability. It also implies the need for a coherent national enterprise development strategy which links sound macroeconomic policies and sectoral policies with firm-level efforts to attain and maintain competitiveness, thus leading to the development of a "national system of innovation" (Nelson and Winter, 1982, Lundvall, 1988).

82. The new context offers novel opportunities for enterprise development, particularly in developing countries, in respect of access to finance, new technologies and global linkages for production and trade. At the same time, it also creates formidable **challenges** to the development of enterprises in developing countries and to the role that such enterprises can play in strengthening national economies. First among these challenges is that, as major global firms speed up the process of innovation in processes and products so as to maintain, and eventually expand, their technological lead vis-à-vis newcomers, the latter, particularly those in developing countries, are under pressure to keep up and accelerate the process of technological absorption and innovation, whether through in-house capabilities or through the establishment of appropriate inter-firm linkages.

83. Another challenge springs from the fact that the new situation in the world economy makes it difficult, if not impossible, to replicate some past models of enterprise development, however successful such models may have been. For example, the traditional import-substitution strategies that permitted a number of emerging economies to develop industrial capacity may encounter difficulties if implemented in the current context. Three new phenomena tend to reduce the scope and efficacy and even the viability of such policies: (i) the Uruguay Round agreements which restrict, from a legal angle, the margin of manoeuvre of WTO members in resorting to trade protection; (ii) the high degree of integration and fierce competition which prevail in world markets, which oblige enterprises, including those at an infant stage, to secure inputs from the best possible source, whether domestic or foreign, in terms of price, quality and continuity of supply; and (iii) the increasing weight of services in world trade which, by their very nature, cannot be protected by tariffs and other barriers as easily as manufactured goods. This is not to say that success stories should not be studied; on the contrary, there is a great deal to learn from them. It is not to say either that a judicious resort to temporary infant industry protection should be

ruled out. What is being argued rather is that past success stories cannot be fully replicated. Just as the nineteenth century industrialization experience of European and North American countries was not fully duplicated by Asian latecomers, the success of the latter has contributed irreversibly to changes in the world economy such that the path which they followed is no longer fully applicable to the new conditions. To a large extent, therefore, the past can serve better as a guide than as a blueprint and much depends on the ingenuity and originality of developing countries in their attempts to develop and strengthen their enterprise base.

84. At the same time, there is a **great diversity of developing countries** and of their situations and problems. This diversity is related to the economic characteristics of individual developing countries and to the level of development of their enterprises. Natural resource endowments, the level of development of the industrial base and of the physical and communications network, the size of the domestic market and the degree of integration of the domestic economy, the technological capacity and availability of adequate human capital in terms of skills, and the proximity to major production and consumption poles are elements in which developing countries also exhibit differences among themselves. Such differences have a significant bearing on the manner in which enterprise development can best be pursued in each of these countries. For example, there are developing countries which have little or no industrial capacity and underdeveloped infrastructure, institutions and markets, with the private sector in general and modern firms in particular, except for mining and plantations, at an early stage of development. Such countries are mainly LDCs, most of which are located in sub-Saharan Africa. For these countries, the main issue is how to speed up the creation of supply capacity through the mobilization of adequate resources, both domestic and foreign, for the development of productive capacity (physical, human and institutional), a necessary first step towards building up export capabilities. Consequently, their main concerns are quite different from those of other developing countries which have already developed some industrial base but which need to improve their productivity and efficiency in order to penetrate international markets or of those developing countries which have developed competitive enterprises and significant export capacity, such as the newly industrializing countries (NICs) and a number of second-tier NICs, but which need to sustain their export capabilities by a process of continuous upgrading and productivity improvement. However, in all cases, innovation, in its broad sense, plays an important role in achieving competitiveness. To move from one stage of their development to another, firms need to upgrade their ability to innovate and to adapt to changing circumstances and needs.

85. There is also diversity related to the strategies of the world's major firms. Transnational corporations are not a uniform group, all behaving in an identical manner and pursuing identical objectives. Their strategies, for example, differ with regard to the intended kinds of investments in developing countries. Some firms tend to attach greater importance than others to such matters as the use of local resources, decentralization of decision-making, and recourse to subcontracting and other inter-firm arrangements. Moreover, their strategies may be more or less responsive, and adaptive, to policy incentives introduced by Governments of developing countries. This diversity

poses a challenge to developing countries to design policies which attract appropriate foreign firms and induce such firms to conform to national objectives related to enterprise development.

86. The result of this double diversity is a very wide spectrum of policy options, requiring careful research and policy analysis in order to ascertain their suitability to particular national contexts. The choice of the appropriate policy option is all the more important for LDCs. The fierce international competition and the ever growing ability of well established firms to penetrate remote and underdeveloped markets makes it increasingly difficult for enterprises in low-income countries, in particular the LDCs, to survive, let alone compete, unless strong supportive action is taken so as to redress the structural handicaps confronted by these firms. Faced with the related phenomena of a large informal sector and a "missing middle" in their enterprise structure, LDCs need to take specific measures, in the context of their enterprise development strategies, targeted at helping their micro and small enterprises to grow and drawing them into the formal sector, through the development of an infrastructural and human resource base, the strengthening of their technological capabilities, and the provision of finance, training and other business support services. Strong international support is needed if LDCs are to succeed in their efforts.

## G. Concluding observations

87. The above discussion has highlighted the need for further work on the issues identified in this chapter related to the formulation and implementation of successful enterprise development strategies. This may take the form of further research in specific areas, as suggested above, in conjunction with exchanges of country experiences, in order to draw lessons from practical experiences and to identify "best practices". Such work may also require international support for related activities at the national level, including technical cooperation activities to strengthen national policy and institutional instruments, and the domestic capabilities needed for this purpose, in the specific areas concerned.

Notes

1/ The pooling of technological competencies to develop the digital videodisc recorder is a case in point.

2/ The evidence for the direct link between competition and innovation is discussed in detail in Mytelka (ed.) (1996a).

3/ Service firms will also be considered to the extent that they are related to the operation of industrial firms.

4/ For an analysis of the experiences of the LDCs in technology transfer and development, see UNCTAD (1990).

5/ The informal sector refers to unregistered microenterprises (often with a workforce of no more than 10 employees, although nowadays it is common to find informal sector enterprises with more than 10 employees). The major features of informal sector enterprises identified in the literature include: non-compliance with legal (e.g. legislation concerning minimum legal wage) and administrative rules; a reliance on family labour; limited access to official credit facilities; easy entry into the sector, especially in terms of initial capital and skill requirements; and the utilization of simple technology which in most cases originates locally. See, Schmitz, (1982).

6/ Such economies occur when production costs per unit of output depend inversely on the size of the firm, and not on that of the industry or sector as a whole.

7/ These economies take place when production costs per unit of output depend on the size of the sector or industry concerned, and not on that of any one enterprise.

8/ It should be noted that subcontractual arrangements between large and small companies may be governed by various motives. These may arise from personalized association characterized by mutual sharing of knowledge and skills and cooperative technological innovation and diffusion. Other considerations on the part of large firms include the desire to maintain quality standards and timely deliveries, through process or product/component specialization (by their smaller counterparts); to access the pool of specialized knowledge and technological capabilities of the subcontracting units; and to reduce output costs (benefiting from lower wages, poorer working conditions and less stringent labour standards in small enterprises).

9/ There are exceptions, as the early history of Silicon Valley shows.

10/ The concept, operations and progress of such spatial economic linkages are examined at some length in M. Thant et al. (1994).

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